1985
ANNUAL REPORT

FEDERAL KIRKLAND MINES LTD.

Annual Meeting

You are cordially invited to attend the Company's Annual Meeting of Shareholders to be held at 2:00 p.m. on Monday, May 26, 1986 in the Banff Room of the Westin Hotel, 320 - 4th Avenue S.W., Calgary, Alberta.

CORPORATE HIGHLIGHTS

Federal Kirkland Mines was founded in August 1983 and has issued 4,500,000 shares for a total of $1,027,262 to the end of 1984. In addition, the Company completed an offering of flow through shares in December 1984 and issued 133,000 shares for net proceeds of $52,890 on February 19, 1985.

In May 1985 the Company entered into a loan agreement with Oceanic Resources Inc. whereas Oceanic loaned the Company $300,000 to be repayed from revenue derived from the Golden Star Tailing project. Oceanic Resources Inc. exercised its option to convert its loan to common shares of the Company on December 31, 1985 and the Company issued 300,000 common shares for a total consideration of $298,450. In January 1986 the Company completed a private placement of 525,000 shares at a subscription price of $0.25 per share and the net proceeds of the issue were $124,643. Subsequent to the year end the Company sold its interest in the Golden Star Tailings Project for share capital of Morning Land Ventures Ltd. valued at $500,000 plus a royalty of 50% of the revenues from mining the tailings.

OPERATIONS

MINING

Craig and Ulster Townships

In November 1985 Federal Kirkland completed Phase II of an exploration program on 20 zinc/silver claims in Craig and Ulster Townships in Northern Ontario. By completing Phase II the Company has now earned its 50% interest in the property and has been registered on title.

Federal Kirkland's Craig-Ulster Townships property is a classic stratabound massive sulfide deposit. This means that the deposit has the geologic potential to extend for thousands of feet along strike and downdip. It also has the potential for changes in ore composition, grade and geometry.

The Craig-Ulster property has three known sulfide zones near surface. Two of them, the West and East Sulfide Zones, have been known since the 1920's. The West Sulfide Zone is roughly 190 feet long, 7.25 feet wide and plunges at 75° westerly to the 850 foot level. Grade is in the 3% to 4% zinc range with 3.30 ounces per ton of silver and minor copper and lead values. Inferred reserves for the West Sulfide Zone is 130,000 tons.

The East Sulfide Zone was described by Preston East Dome Mines Ltd. (1952) as being 1500 feet long with an average width of 8.6 feet to the 250 foot depth. Preston estimated 360,000 tons of sulfide grading 3.18% zinc, 0.32% copper and 0.68 ounces per ton silver.

The New East Zone was a joint 1984 discovery by Stralak Resources and Federal Kirkland Mines Ltd. The zone is known to be at least 1000 feet long and from 5 to 17 feet wide. Proven reserves in the New East Sulfide Zone to date are 241,335 tons averaging 5.22% zinc, 0.37% copper, 0.74% lead and 2.54 ounces per ton silver. Another 98,637 tons of probable reserves of similar grade is known. If the zone continues to the 1000 foot level along a 1000 feet of strike length with our average 10.4 foot width, inferred tonnage would be 1,155,000 tons.

Thus Federal Kirkland Mines Ltd.'s Craig-Ulster property contains geologically inferred reserves of:

West Zone	130,000 Tons
East Zone	360,000 Tons (open)
New East Zone	1,155,000 Tons (open)
Total Tonnage	1,645,000

Golden Star Tailings

Due to production problems, the Company shut down the Golden Star Tailings Project in 1985. After re-evaluating the project, Federal Kirkland decided it was in the best interest of the shareholders to dispose of the property and the equipment.

PETROLEUM AND NATURAL GAS

Although no new properties were acquired and no wells drilled during the current fiscal year, the Company has nevertheless been evaluating business opportunities on a selective basis. Despite current price instability, the original purchase (1984) of proven and semi proven properties has been borne out to be a prudent investment, with payout anticipated well within the forecast three year time frame. Revenue from these properties during 1985 was $114,366 including A.R.T.C., from two producing oil wells and eight producing gas wells. Estimated net proven producing reserves are 2,500 bbls. of oil and 200 mmcf of natural gas.

In addition, the Company has net non-producing gas reserves in excess of 3,700 mmcf, involving 11 shut in gas wells located mostly in the area generally west of Edmonton. We will continue our attempts to bring these properties on stream at the earliest possible date or to realize a reasonable profit through sale or trade of these assets.

As of December 31, 1985 Federal Kirkland held working interests in a total of 24,602 gross acres (1,412 net and after payout where applicable), plus royalty interests in a further 2,814 gross acres, all in Alberta.

Sherwood J. Young
President

Halpin, Martian & Partners
CHARTERED ACCOUNTANTS

Auditors' Report

To the Shareholders of
Federal Kirkland Mines Ltd.

We have examined the balance sheet of Federal Kirkland Mines Ltd. as at December 31, 1985 and the statements of earnings and deficit and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these financial statements present fairly the financial position of the company as at December 31, 1985 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Calgary, Alberta
February 28, 1986

Halpin Martian & Partners
Chartered Accountants

Balance Sheet

As at December 31, 1985

	1985	1984
Assets		
CURRENT		
Cash	$ —	$ 57,345
Accounts receivable	21,948	70,186
Prepaid expenses and deposits	8,252	—
Advances to a director	—	17,993
	30,200	145,524
PETROLEUM AND NATURAL GAS INTERESTS (Note 2)	279,799	269,531
MINERAL PROPERTIES AND EQUIPMENT (Note 3)	880,899	414,897
DEFERRED ADMINISTRATION COSTS (Note 4)	208,045	168,725
FIXED ASSETS (Note 5)	7,274	9,092
LEASE DEPOSIT	1,200	1,200
	$1,407,417	$1,008,969
Liabilities		
CURRENT		
Bank loan and advances (Note 6)	$ 119,021	$ —
Accounts payable and accrued liabilities	120,975	44,774
	239,996	44,774
Shareholders' Equity		
SHARE CAPITAL (Note 7)	1,378,610	1,027,262
FLOW-THROUGH UNITS	—	52,890
DEFICIT	(211,189)	(115,957)
	1,167,421	964,195
	$1,407,417	$1,008,969

Approved by the Board:

Sherwood J. Young, Director
(Signed)

Norman J. Mackenzie, Director
(Signed)

Statement of Earnings and Deficit

For the Year Ended December 31, 1985

	1985	1984
PRODUCTION REVENUE		
Gas and oil sales	$ 87,028	$ 65,925
Royalty income	22,232	4,565
Alberta Royalty Tax Credit	5,106	4,776
	114,366	75,266
PRODUCTION EXPENSES		
Administration costs	51,701	15,700
Operating costs	29,333	2,159
Crown royalties	10,213	9,552
Other royalties	6,323	8,950
Depletion	3,858	12,662
Petroleum tax	3,788	502
	105,216	49,525
PRODUCTION INCOME BEFORE OTHER ITEMS	9,150	25,741
OTHER ITEMS		
Sale of royalty interest	10,000	—
Write down of deferred administration costs (Note 4)	(114,382)	—
Cost of abandoned claims	—	(25,755)
	(104,382)	(25,755)
NET LOSS FOR THE YEAR	95,232	14
DEFICIT — Beginning of Year	115,957	115,943
DEFICIT — End of Year	$ 211,189	$115,957

Statement of Changes in Financial Position

For the Year Ended December 31, 1985

	1985	1984
SOURCES OF WORKING CAPITAL		
Operations		
Net (loss) for the year	**$ (95,232)**	$ (14)
Non-cash items:		
Write down of deferred administration costs	**114,382**	—
Depletion	**3,858**	12,662
Funds provided from operations	**23,008**	12,648
Issuance of share capital	**298,458**	806,250
Issuance of flow-through units	**—**	66,500
	321,466	885,398
APPLICATIONS OF WORKING CAPITAL		
Construction of gold recovery equipment and pre-operating costs	**233,815**	181,248
Joint venture exploration costs	**214,687**	204,629
Payment of deferred administration costs	**151,884**	160,810
Payments on mineral claim assignment	**17,500**	12,500
Petroleum and natural gas expenditures	**14,126**	282,193
Purchase of fixed assets	**—**	5,554
Payment of share issue expenses	**—**	142,739
Payment of flow-through units	**—**	13,610
	632,012	1,003,283
DECREASE IN WORKING CAPITAL FOR THE YEAR	**310,546**	117,885
WORKING CAPITAL — Beginning of Year	**100,750**	218,635
WORKING CAPITAL (DEFICIENCY) — End of Year	**$(209,796)**	$ 100,750

Notes to the Financial Statements

For the Year Ended December 31, 1985

1. ACCOUNTING POLICIES

Petroleum and Natural Gas Interests

The company follows the full cost method of accounting for petroleum and natural gas properties, under which all costs related to exploration and development are capitalized. These costs include those related to property acquisitions, geological and geophysical activities, carrying charges of non-producing properties and drilling of productive and non-productive wells. The costs capitalized are depleted on the unit-of-production method based on estimated proven reserves. Any excess of the recorded costs over the present value of future net revenues from the properties is charged against operations in the year such impairment occurs.

Mineral Properties and Equipment

The exploration and development costs of mineral properties are capitalized and will be amortized on the unit-of-production method when production commences. Costs are charged against operations if the property is abandoned. All such costs incurred to December 31, 1985 represent costs associated with non-producing properties.

Gold recovery equipment is stated at cost and will be depreciated when production commences using the diminishing balance method at a rate of 30% per annum.

Deferred Administration Costs

Administration costs are allocated to properties in proportion to the exploration and development costs incurred on each property. Such administration costs are reduced by the amount of any incidental income such as interest earned. Costs allocated to producing or abandoned properties are charged against operations. Any excess of the recorded costs over the present value of future net revenues is charged to operations in the year such impairment occurs.

2. PETROLEUM AND NATURAL GAS INTERESTS

The petroleum and natural gas interests consist of the following:

	1985	1984
Petroleum and natural gas interests	**$296,319**	$282,193
Less: Depletion	**16,520**	12,662
	$279,799	$269,531

3. MINERAL PROPERTIES AND EQUIPMENT

	1985	1984
Craig Township Joint Venture	**$420,384**	$205,697
Golden Star Tailings Project	**460,515**	209,200
	$880,899	$414,897

Craig Township Joint Venture

The joint venture was formed on December 15, 1983 in order to implement an exploration program on twenty unpatented mineral claims. Under the terms of the Joint Venture Agreement the company is responsible for the costs of a two phase exploration program to earn an undivided 50% interest in the claims. Subsequent to the year end the venturers agreed that the company had fulfilled the terms of the agreement and has earned its 50% interest in the claims.

4. DEFERRED ADMINISTRATION COSTS

Deferred administration costs are as follows:

	1985	1984
Balance — Beginning of year	**$168,725**	$ 5,640
Deferred in the year	**153,702**	163,085
	322,427	168,725
Write down to net realizable value	**114,382**	—
Balance — End of year	**$208,045**	$168,725

The company wrote down the deferred administration costs related to the Golden Star Tailings Project by $114,382 to reduce total direct and deferred costs capitalized on the project to the subsequent sale proceeds.

5. **FIXED ASSETS**

Fixed assets are stated at cost, net of depreciation of $4,093. Depreciation is computed on the declining balance basis at a rate of 20% per annum.

6. **BANK LOAN AND ADVANCES**

The bank loan of $119,000 bears interest at prime plus 1% per annum and is secured by an assignment of book debts and Section 178 security on certain of the petroleum and natural gas interests.

7. **SHARE CAPITAL**

The company's authorized share capital consists of an unlimited number of common shares of no par value. Details of the changes in the companies capitalization during the year are as follows:

	Shares	Amount
Balance — Beginning of year	4,500,000	$1,027,262
Issued:		
Flow through shares	133,000	52,890
Conversion of loan payable	300,000	298,458
Balance — End of year	4,933,000	$1,378,610

(i) The company completed an offering of flow through shares in December, 1984 and issued 133,000 shares for net proceeds of $52,890 on February 19, 1985. The company expended $42,517 on petroleum and natural gas exploration and $10,313 on mineral exploration. For income tax purposes these costs are deemed to have been incurred by the shareholders. Accordingly, the company is not entitled to any deduction for income tax purposes with respect to these costs.

(ii) Oceanic Resources Inc. exercised its option to convert its loan payable to common stock on December 31, 1985, and the company issued 300,000 common shares for a total consideration of $298,458.

(iii) In January, 1986, the company completed a private placement of 525,000 shares at a subscription price of $0.25. The net proceeds of the issue are $124,643. At the year end, the company had received $62,485 which was held in trust until the share offering was closed.

(iv) 500,000 common shares have been reserved as follows:
350,000 shares for options to Directors and Management and 150,000 shares for options to employees. At December 31, 1985 options for 200,000 shares have been granted at 40 cents per share expiring on December 15, 1988.

8. **LOSS CARRY FORWARD FOR INCOME TAX PURPOSES**

The company has losses carried forward for income tax purposes approximating $485,557 which are available for the reduction of taxable income in future years. These losses expire as follows:

1990	$ 43,738
1991	301,581
1992	140,238
	$485,557

No recognition has been given in these financial statements to any potential tax savings arising from the application of the above losses.

9. **REMUNERATION OF DIRECTORS AND SENIOR OFFICERS**

The aggregate remuneration paid to shareholders in their capacity as directors and officers of the company during the period amounted to $74,920 (1984 - $59,000).

10. **LEASE COMMITMENT**

The company has an existing lease commitment on office premises, expiring December 31, 1988, at a minimum annual rental approximating $11,000.

11. **SUBSEQUENT EVENT**

Subsequent to the year end, the company sold its interest in the Golden Star Tailings Project for share capital of Morning Land Ventures Ltd. valued at $500,000 plus a royalty of 50% of the revenues from mining the Golden Star Tailings Project or future leasing of the equipment.

Corporate Head Office

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Directors and Officers

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Calgary, Alberta

Norman J. Mackenzie
Secretary-Treasurer
and Director
Calgary, Alberta

John F. K. Donaldson
Director
Edmonton, Alberta

Bernard Davies
Director
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T. E. Morimoto
Director
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Share Information

Trades: Alberta Stock Exchange
Trading Symbol: **FKL**

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